Impax
ASSET MANAGEMENT

Investing in Resource Efficiency Stocks

A COMPELLING COMPLEMENT TO AN INSTITUTIONAL PORTFOLIO

For professional Investors – September 2014

Investing in Resource Efficiency Stocks

1. COMPELLING LONG TERM DRIVERS OF CHANGE

The long term trends around resource supply and consumption can be described through four investment themes:

Rapidly growing demand for resources
Driven by an expanding global population and rising standards of living and urbanisation, particularly in (populous) developing markets

Limitations to cost-effective resource supply
Higher marginal costs of production for many key resources, e.g., oil, rare earth minerals

Inadequate infrastructure
Greater demand for new infrastructure in developing economies alongside repair and replacement in developed economies

Environmental constraints
Limits on clean water availability, rising exposure to flooding, contaminated air, soil pollution, and growing impacts from climate change against a backdrop of ever stricter environmental policy around the world

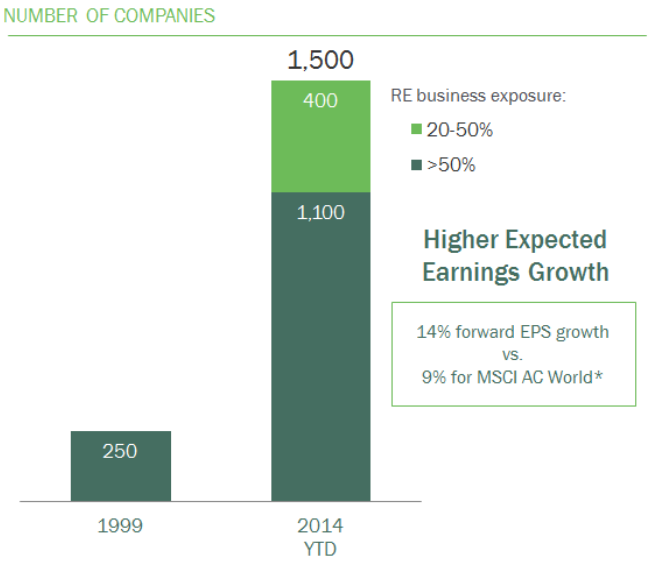
2. A SIGNIFICANT UNIVERSE OF DIFFERENTIATED STOCKS WITH SUPERIOR GROWTH

Over the last decade we have witnessed the rapid emergence of a large universe of listed companies that are focused on Resource Efficiency. The RE universe (as defined by FTSE) currently comprises approximately 1500 stocks and has an aggregate market capitalisation in the region of US$4 trillion[1] (see Figure A).

The RE universe demonstrates superior growth potential. Over the next 3 to 5 years, RE stocks are, on average, expected to grow revenues by 6.1% annually (compared to 5.6% annually for the MSCI ACWI)[2] and earnings by 14.6% annually (compared to 11.8% for the MSCI ACWI) ; in contrast, the equivalent forecast for the oil and gas sector is 8.3%[3].

Additionally, there is limited overlap between the RE universe and mainstream indices, e.g. as of end of March 2014 the overlap between the RE universe and the MSCI All Country World Index ("ACWI") was less than 6%[4]. Other considerations include that RE stocks tend to have low leverage. The Debt/Equity ratio of the RE universe is today 47% vs 74%[5] for the MSCI ACWI. RE stocks are also not well covered by sell-side analysts, providing many opportunities for specialist managers to add value.

Figure A: Impax Investment Universe is Growing Rapidly



RE markets are not well understood and are frequently mispriced

Based on Impax's proprietary environmental markets database.
This database is used to help construct the FTSE Environmental Markets Index Series.
*Source: FactSet, as at 31 March 2014. Forward EPS growth data for FTSE EOAS as a proxy for the resource efficiency sector.

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3. A HEDGE AGAINST EMERGING SYSTEMIC RISKS

As many investors experienced during the recent financial crisis, systemic risks (such as the collapse of the housing market) build slowly and can be hard to protect against. Unfortunately, many investors may not appreciate and/or may be under-protected against today's emerging systemic risks, some of which are likely to be high magnitude. As summarised in Figure B, a Resource Efficiency portfolio can provide a hedge against a number of such emerging risks, for example:

Water supply

Water availability has evolved from a location specific issue to a structural/strategic challenge. For example, the current drought in California is the worst in history, with an economic impact estimated to be around US$2.2 billion, mainly in agriculture[6]. **Investment in stocks that provide civil engineering, water treatment, and related services in the water sector can hedge this agriculture resource risk.**

Policy to limit location-specific pollution

With rising population levels, urbanisation and wealth, pollution is becoming a global concern, and regulations to constrain or ban emissions to air, water and/or soil are becoming tighter and more widespread. For example, recent regulations limiting emissions from coal-fired power stations have contributed to US coal stocks under-performing a basket of US energy stocks by 70 percentage points since 2011[7]. **Investment in pollution control and hazardous waste management stocks can offset this risk.**

Policy to address climate change

Climate change, principally from burning fossil fuels, is an increasing concern globally. A typical investor's equity portfolio has 7 to 10% exposure to fossil fuel companies, which may suffer value destruction as regulators impose charges or limitations on fossil fuel combustion, thereby both raising the price of energy to consumers and lowering the price of energy received by producers. **A portfolio of energy efficiency and renewable energy stocks offers a counterweight to this risk.**

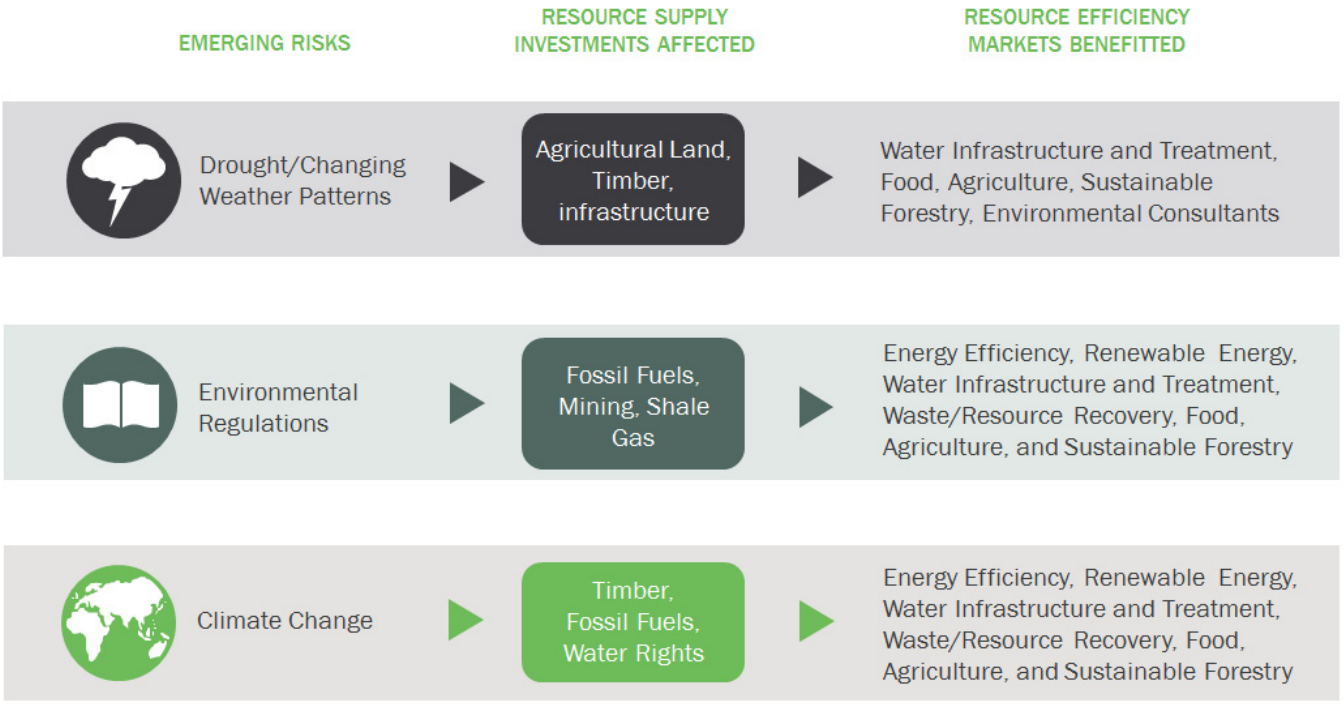
Extreme weather

Incidence of severe weather events is rising, e.g. flooding in Europe and Canada in 2013 caused ~$20bn of damage[8], while the insured losses from Hurricane Sandy are expected to reach $35bn[9]. **Companies that provide flood prevention infrastructure and environmental monitoring systems are set to benefit from investments to mitigate the impact of extreme weather.**

Technology substitution

Incentivized by higher energy prices and/or policies, **companies rolling out new, proven energy efficiency technology can accelerate obsolescence in other areas.** For example, LED-based lighting is expected to grow from 15% (in 2013) to 45% of the global lighting market by 2016[10], replacing conventional lighting.

Figure B: Hedging Risks to Resource Supply Investments



Source: 'Expect the Unexpected: Building business value in a changing world', KPMG report 2012.

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4. ACTIVE MANAGEMENT OF LISTED EQUITIES BEATS PASSIVE STRATEGIES AND VENTURE CAPITAL

Impax has been researching the investment opportunities available to investors seeking Resource Efficiency equity exposure for 16 years. Our research has shown that active management of listed equities is optimal for four reasons:

Inherent pricing inefficiency

RE markets are highly complex with materially higher exposure to technology developments, regulatory change and corporate activity than is found in the broader economy. These complexities lead to frequent mis-pricings in the stocks of RE companies from which a specialist manager can benefit.

Under-researched companies

The median number of analysts covering RE stocks is 13, while the corresponding number for stocks in the MSCI ACWI is 20[11]. Accordingly, an experienced specialist investment team should be well placed to develop profitable insights into less covered companies.

Broad scope for portfolio construction

The RE universe comprises a wide range of liquid cyclical and defensive stocks, providing the active investor with scope to tailor an RE portfolio to suit a variety of market conditions across the short, medium and long-term.

More favourable risk/return characteristics than venture capital

Market and technology complexity means venture investments have particularly high, security-specific risks. Our analysis indicates that the poor returns from most venture capital investments in the RE sector over the past decade can be explained by the impact on relatively concentrated portfolios of adverse policy and regulatory changes, for example China's decision to dominate the market in solar panels drove down prices by ~ 80%[12] in five years and destroyed the business models of many venture backed entrants.

5. RECOMMENDED PORTFOLIO POSITIONING

For a variety of reasons, many investors have historically allocated Resource Efficiency stocks to their environmentally focused ESG or SRI baskets. Some will continue to do so but the appeal of RE investing is now much broader. As shown in Figure C, we believe that institutional and other investors should consider the role of a portfolio of actively managed RE stocks to be:

A diversifier to global equity

Providing higher growth opportunities through exposure to a universe of stocks that is not typically found elsewhere in a typical global equity portfolio.

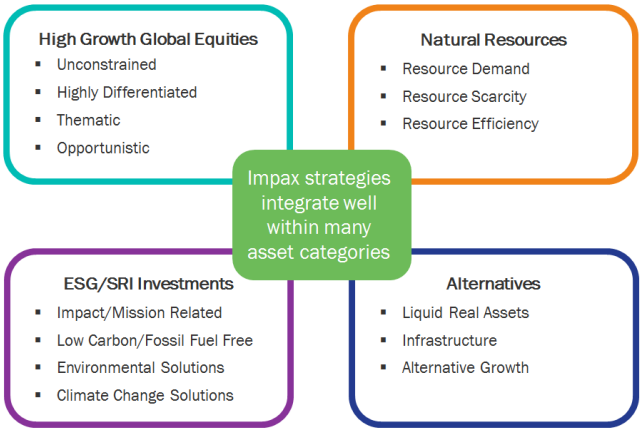
A hedge for natural resources or fossil energy exposure

Broadening resource oriented portfolios to RE investments with similar commodity factor exposure and natural hedges against emerging "fat-tail" risks ; or

A complement to liquid real assets

RE portfolios typically have a high exposure to infrastructure and related markets, and so may complement other public and private markets approaches.

Figure C: Where Does Resource Efficiency Belong in a Portfolio?



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6. CONCLUSION

Globally, economic growth looks set to maintain an upward trend over the next few years but is likely to be geographically patchy. Investors seeking higher, long-term returns need to examine carefully how they are positioning their portfolios for emerging growth opportunities and for emerging risks.

The inexorable trend of rising resource demand amidst resource constraints provides the backdrop to a compelling investment case for Resource Efficiency, where many investors are under-allocated. There is strong evidence that a portfolio of RE securities can complement and enhance a typical global equity profile. The rapid pace of change in technology, regulations and policy, combined with low levels of analyst coverage lead to a prevalence of mis-pricing in these markets, underpinning the need for active investment management.

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Disclaimer

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[2] Factset, FTSE Environmental Opportunities All Share and MSCI All Country World as at 31 March 2014

[3] Factset, MSCI All Country World as at 31 March 2014

[4] Factset, MSCI All Country World vs. FTSE Environmental Opportunities All Share as at 31 March 2014

[5] Factset, FTSE Environmental Opportunities All Share as at 31 March 2014

[6] AgFunder News, "5 Things You Should Know About the California Drought" " as at 18 July 2014 - taken from http://agfundernews.com/5-things-know-californias-record-drought.html

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